

ANALYSIS OF ORIGINAL BILL

Author: Hurtt Analyst: Marion Mann DeJong Bill Number: SB 1425

Related Bills: See Legislative History Telephone: (916) 845-6979 Introduced Date: 01/22/98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Shift Burden Of Proof

SUMMARY

This bill would shift the burden of proof from taxpayers to the "board" in court proceedings under certain conditions.

EFFECTIVE DATE

This bill would be effective January 1, 1999.

LEGISLATIVE HISTORY

AB 1433, AB 1631, AB 1633, SB 1166.

BACKGROUND

H.R. 2676, which is known as the "Internal Revenue Service Restructuring and Reform Act of 1997," contains 31 provisions under the title Taxpayer Protection and Rights. One such provision would shift the burden of proof in court proceedings from the taxpayer to the Internal Revenue Service (IRS). Under the proposed federal bill, the burden of proof shift would not apply to partnerships, corporations or trusts whose net worth is more than \$7 million. In addition, the burden-of-proof shift would apply only if the taxpayer has fully cooperated with the IRS, "including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer, as reasonably requested." The provision would apply to court proceedings arising in connection with examinations commencing after the date of the enactment of the Act.

This proposed legislation passed the House of Representatives on November 5, 1997. The Senate is expected to hold hearings early this year and produce its own version of IRS restructuring legislation by spring.

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___X___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director

Gerald H. Goldberg

2/10/98

Agency Secretary

Date

By:

Date:

SPECIFIC FINDINGS

Under federal law, taxpayers may be requested by the IRS to substantiate items reflected on their federal income tax returns. The IRS may issue a deficiency assessment based on: taxpayers' inability to substantiate items reflected on their income tax return or third party information returns (W-2s, 1099s, etc.). If collection is determined by IRS to be in jeopardy, a jeopardy assessment is issued, whereby the amount of the deficiency is immediately due and payable. Taxpayers may protest deficiency assessments or jeopardy assessments to the IRS. In the event the assessment is sustained, under the federal appeals system, the Tax Court (which has a small claims division for amounts of \$10,000 or less), a U.S. district court or the U.S. Court of Claims is the first level of review of IRS actions. In these reviews, a rebuttable presumption exists that the IRS's determination of tax liability is correct. Taxpayers have the burden of proving that the IRS's action was incorrect and establishing the merits of their claims by a preponderance of the evidence. This review is an independent judicial review by a trial court upon evidence submitted by the parties. Both the taxpayer and the IRS can bring actions in appellate courts to appeal final adverse determinations, except small claims division determinations, which are binding.

Under current Personal Income Tax Law (PITL) and Bank and Corporation Tax Law (BCTL), taxpayers may be requested by the Franchise Tax Board (FTB) to furnish substantiation of the items reflected on their income tax returns. The FTB may issue a proposed deficiency assessment based on: taxpayers' inability to substantiate items reflected on their income tax return, third-party information returns (W-2s, 1099s, etc.), or information FTB receives from IRS. In the rare instance that collection is determined by FTB to be in jeopardy, a jeopardy assessment is issued whereby the amount of the deficiency is immediately due and payable.

Taxpayers protest the issuance of a proposed deficiency assessment or jeopardy assessment by filing a written "protest" with the FTB. The FTB staff reviews the protest and grants an oral hearing upon request by the taxpayer. The taxpayer's forum for appealing FTB's action on that protest is the Board of Equalization (BOE), as follows:

- if FTB has denied a taxpayer's protest of a proposed deficiency assessment;
- if FTB has denied a claim for refund or failed to act on the claim within six months after it is filed;
- if FTB has disallowed interest on a refund claim; or
- if FTB has issued a "jeopardy" deficiency assessment and denied the taxpayer's charge that collection was not in jeopardy.

The BOE is the first independent administrative level of review of an FTB action. During the appeal process, the BOE makes an independent determination of the action. The BOE accepts evidence submitted by the taxpayer and, if requested by the taxpayer, grants an oral hearing on the matter. In the independent review by BOE, there is a rebuttable presumption that the FTB action was correct. Hence, taxpayers have the burden of proving that the FTB's action was incorrect and establishing the merits of their claims by a preponderance of the evidence.

In the event of a final adverse BOE decision, the taxpayer's recourse is to pay the amount due, and file a claim for refund. After denial of the claim (or a failure by the department to act on the claim within six months), the taxpayer may bring an action for refund against the state in Superior Court. With residency matters payment is not required. In litigation, as with appeals, there is a rebuttable presumption that the FTB action was correct. In addition, a taxpayer in a suit for refund is the plaintiff. Consequently, taxpayers (like plaintiffs in other civil actions) have the burden of proving that the FTB's action was incorrect and establishing the merits of their claims by a preponderance of the evidence.

This bill would shift the burden of proof from the taxpayer to the FTB for litigation cases provided the taxpayer shows prima facie justification for the factual or legal contention and fully cooperates with the board in disclosing all relevant evidence. This bill would not be construed to override any requirement under the PITL, Administration of Franchise and Income Tax Laws and Regulations (AFITL) or B&CTL to substantiate any item.

Policy Considerations

The provisions of this bill would raise the following policy considerations.

- Generally in civil cases the burden of proof is on the plaintiff, the party seeking corrective action. In addition, for tax cases the taxpayer has control of records and documents.
- Supporters of this proposal point to the discussion of the proposed federal legislation (H.R. 2676). Members of the Ways and Means Committee said they were "concerned that individual and small business taxpayers frequently are at a disadvantage when forced to litigate with the IRS. The Committee believes that the present burden of proof rules contribute to that disadvantage. The Committee believes that, all other things being equal, facts asserted by individual and small business taxpayers that fully cooperate with the IRS and satisfy all relevant substantiation requirements should be accepted. The committee believes that shifting the burden of proof to the Secretary in such circumstance will create a better balance between the IRS and such taxpayers, without encouraging tax avoidance."
- The burden of proof provision of this bill does not conform to the proposed federal provision. The language provided in this bill does not: (1) limit the burden of proof shift to the smaller taxpayers, (2) define what is considered "taxpayer cooperation," and (3) limit the provision to court proceedings arising in connection with "examinations" commencing after the date of enactment.
- Opponents argue that shifting the burden of proof could lead to reduced compliance and result in more intrusive audits to substantiate the accuracy of an assessment. Residency and unitary audits would be more difficult since the information may be outside the state.

Implementation Considerations

The provisions of this bill would raise the following implementation considerations. Department staff is available to help the author resolve these concerns.

- The terms "prima facie justification" and "cooperates fully" are not defined. If the intent is to pattern California law after the federal provision, it may be better to conform by referencing the federal provision so that federal regulations (which should be provided by the IRS to clarify these terms) are effective for California purposes.
- Shifting the burden of proof on litigation cases would most significantly affect claims for refund that are deemed denied, residency or unitary cases, and claims in bankruptcy and probate court proceedings. In refund cases, the department may not have had an opportunity to obtain supporting documents from the taxpayer. It is unclear whether the audit staff would be required to seek additional supporting data for all cases to protect the state's interest in the event the case is litigated.
- Currently, FTB generally retains taxpayer records for a period of three to four years and then destroys them, as authorized under R&TC Section 19530. Shifting the burden of proof to the department may require longer retention of records and increased costs for storage.
- Under certain conditions, this bill would shift the burden of proof to FTB in ascertaining the "income tax liability" of a taxpayer. It is unclear whether the burden of proof would be shifted to the FTB on issues related to penalty and interest. This ambiguity derives from the fact that current law is unclear as to whether penalty and interest are an addition to, and therefore, part of the tax, or something separate and apart from the tax.

Technical Considerations

The bill makes reference to the "board" as an apparent reference to the FTB. However, under the PITL, AFITL and BCTL, reference to the "board" means the BOE. Amendments 1 and 2 would change "board" to "Franchise Tax Board."

FISCAL IMPACT

Departmental Costs

The departmental costs associated with this bill are unknown. The costs could increase, however, to the extent that additional supporting evidence would be required on all cases to support the state's position on any cases that are litigated.

Tax Revenue Estimate

The revenue loss for this bill would be determined by those assessments that may be revised due to incomplete documentation to support the assessment and revenues lost from possible negative effects on voluntary compliance.

Revenue losses in any given year are unknown. It is not possible to determine the number of cases in which the outcome would be changed because of the shift in the burden of proof. It is not clear how the courts would define "fully cooperate."

The Joint Committee on Taxation in its revenue estimate of H.R. 2676 estimated that shifting the burden of proof would result in a cumulative revenue loss of \$795 million for fiscal years 1998 to 2002. It has been expressed at the federal level that a negative revenue impact from reduced self-assessed reporting may result, which could have an effect on departmental audit programs. Because the language of this bill does not conform to the federal proposed legislation, it is not possible to use the federal revenue impact to measure the impact from this bill.

BOARD POSITION

Pending.

Marion Mann DeJong
(916) 845-6979
Doug Bramhall

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1425
As Introduced January 22, 1998

AMENDMENT 1

On page 2, line 1, strikeout "board" and insert:

Franchise Tax Board

AMENDMENT 2

On page 2, line 6, strikeout "board" and insert:

Franchise Tax Board